Summit Trail Advisors

Qualified Small Business Stock: Navigating the Uncertainties Amid Expanding Opportunities

Summary

Among the few remaining gain exclusion provisions in the US Tax Code, Section 1202's treatment of Qualified Small Business Stock (QSBS) continues to stand out – not just for its scope but for its strategic value. This highly advantageous provision allows noncorporate taxpayers to exclude up to $10 million of gain (or 10 times basis, if greater) on the sale of QSBS. The One Big Beautiful Bill ("OBBB"), enacted on July 4th, 2025, has made these provisions even more compelling.

For many in the start-up and venture world, these changes may reinforce the appeal of C Corporation status, which is a trend fueled by the 2010 expansion of the 100% QSBS exclusion and the post 2017 Tax Act corporate tax rate reduction from 35% to 21%.

By Jose A. Reynoso

Chief Fiduciary Counsel

QSBS Qualification Overview

Before OBBB, the QSBS rules caused considerable consternation because of material ambiguities in certain parts of the law. The recent changes (and any resulting new regulations still to come) will likely continue to make navigating the requirements a challenging process.

Unchanged rules:

- The issuing company must be a domestic C Corporation
- It must meet the active business requirement
- The stock must be acquired at original issuance

Changed rules: The OBBB changes only apply prospectively to QSBS acquired after July 4, 2025.

	Acquired before July 4	**Acquired after July 4**
Gross assets cannot exceed this amount at all times before and immediately after the equity was issued (inflation indexing starting in 2027)	$50m	$75m
The stock must be held for this period prior to sale	5 years	3,4, or 5 years
Amount of gain exclusion (inflation indexing starting in 2027)	$10 million	$15 million
% of gain exclusion allowable	100%	50% 3 years 75% 4 years 100% 5 years

What are the Grey Areas?

Holding Period: 5 Year Holding Period (Now 3,4,5 years)

While the law clearly states that the "old" 5 year holding period requirement starts from the date the stock was issued to the taxpayer, less clarity exists around securities like convertible debt or stock options. Further uncertainty arises when a business is not structured as a QSBS-qualifying entity (such as a partnership) at the outset but later qualifies as a C corporation.

- **Convertible debt**: the holding date starts when the debt converts to equity
- **Stock options**: the period will not begin to run until the options are exercised. The timing of the exercise of stock options can be greatly influenced by the status of the underlying entity (QSBS qualifying or not).
- **Entity conversion**: For companies initially formed as a partnership or a limited liability company (LLC), the holding period typically starts at the time of C-Corp conversion.
- **Simple Agreement for Future Equity (SAFEs)**: Typically issued by newly formed companies, these instruments were not contemplated when the statute was drafted and the IRS has yet to provide definitive guidance.

Presumably, these rules will also apply to the new 3- and 4-year holding periods, but only further IRS guidance will be able to confirm that.

Estate Planning Strategies: "Stacking"

Estate planning strategies have developed around leveraging the benefits of section 1202. Most of these strategies revolve around maximizing the number of individuals / entities eligible for the $10 million exclusion. (Of course, there must be a separate and distinct calculation of the available lifetime exemption for gift and estate tax purposes before making any gifts.) This strategy is generally referred to as "stacking."
Qualifying stock generally retains its characterization when gifted and the holding period transfers as well. As a result, stacking consists of giving QSBS to family members and/or irrevocable trusts (non-grantor trusts), each retaining the eligibility to exclude up to $10 million (or $15 million under the new rules) of capital gains. The unsettled (and sometimes unsettling) questions are "how many trusts and for whom?" Questions remain, particularly around the "anti-avoidance"/ "anti-abuse" provisions in the tax code that can treat multiple trusts as one if they are funded by the same grantor for the same beneficiaries. However, there is a dearth of guidance on the application of these rules and there appears to be no presumption of tax avoidance.

As a result of the limited guidance, a conservative approach typically involves:

- Non-grantor trusts for separate, distinct beneficiaries, generally avoiding overlap.
- A separate additional "pot trust" that may consist of several existing beneficiaries seems to be acceptable to many practitioners. For example, a non-grantor trust for each child with one pot trust for "all descendants."
- And, perhaps, different trustees and varying distributions.

INGs And CRTs

Incomplete non-grantor trusts (INGs) and Charitable Remainder Trusts (CRTs) may also be considered when planning with QSBS. While both trusts raise unresolved income tax issues, they should both be considered sufficiently distinct from other trusts established for family members to be entitled to their own QSBS exclusions. Both INGs and CRTs are separate taxpayers but considered incomplete gifts therefore do not require the use of any of the donor's lifetime exemption.

- **INGs**: They are increasingly being scrutinized at the state level including California and New York (via legislation), therefore, it would be advisable to think through your position carefully if contemplating this strategy.
- **CRTs**: Though not taxable entities, distributions to the annuity beneficiary (ies) follow a prescribed ordering system (i.e. ordinary income, then cap gains, etc.). It remains unclear how QSBS exclusions would fit into this system.

Spouses: One Exclusion or Two?

Whether spouses filing jointly are eligible for two full exclusions remains a tricky and unresolved question. Without taking a position on the matter, there appears to be material support on both sides of the question. A conservative approach suggests only one $10 million exclusion (or $15 million) per couple regardless of whether filing jointly or separately (i.e. currently $5 million each as indicated in the statute for separate filers). Some accountants may be comfortable signing joint returns with both spouses eligible for full exclusions, provided there is a reasonable basis to take the position. While other accountants may only sign that joint return if the position is more fully disclosed. (As with many other questions already presented, the absence of guidance can make certain QSBS decisions particularly fraught (despite the ample benefits). An attorney opinion letter may be particularly useful for this particular question.

Transfers of QSBS

Material questions arise around the "original issuance requirement." To be eligible for QSBS status, the stock must be acquired by the holder at the stock's issuance either in exchange for money and other property (but not other stock) or as compensation for services rendered.

With regard to transfers, it is well-settled that a straight gift of stock to a non-grantor trust from the original holder clearly constitutes a transfer by gift and preserves the QSBS status of the stock.
Ambiguity arises with LLCs:

- If the LLC is treated as a partnership, QSBS status is disallowed.
- Some practitioners don't believe the transfer of LLC units constitutes a gift of the underlying QSBS, thereby negating any benefit.
- Best practice may be to retitle any QSBS in an LLC back into the taxpayer's name and make gifts directly (if possible).

Optimizing QSBS in the Context of Your Wealth Plan

While Section 1202 offers material (and expanded) tax advantages, navigating QSBS eligibility is anything but straightforward. Ambiguities in the law and creative planning strategies aimed at maximizing this unique tax benefit require close consideration.

Supporting a position with regard to QSBS is crucial. The most prudent approach involves engaging experienced professionals and aligning your tax advisors (attorneys, accountants, etc.) before pursuing an aggressive planning position. In some cases, seeking a formal legal opinion is advisable.

Qualified Small Business Stock: Navigating the Uncertainties Amid Expanding Opportunities

QSBS presents a powerful tax incentive to entrepreneurs and investors. With the recent changes under OBBB, these benefits have become even more beneficial and broadly available. As always, thoughtful planning and professional guidance are essential. Summit Trail's dedicated Wealth Planning Team is highly experienced in helping clients evaluate and optimize QSBS strategies as part of a comprehensive, strategic approach to tax-efficient wealth building.

Important information